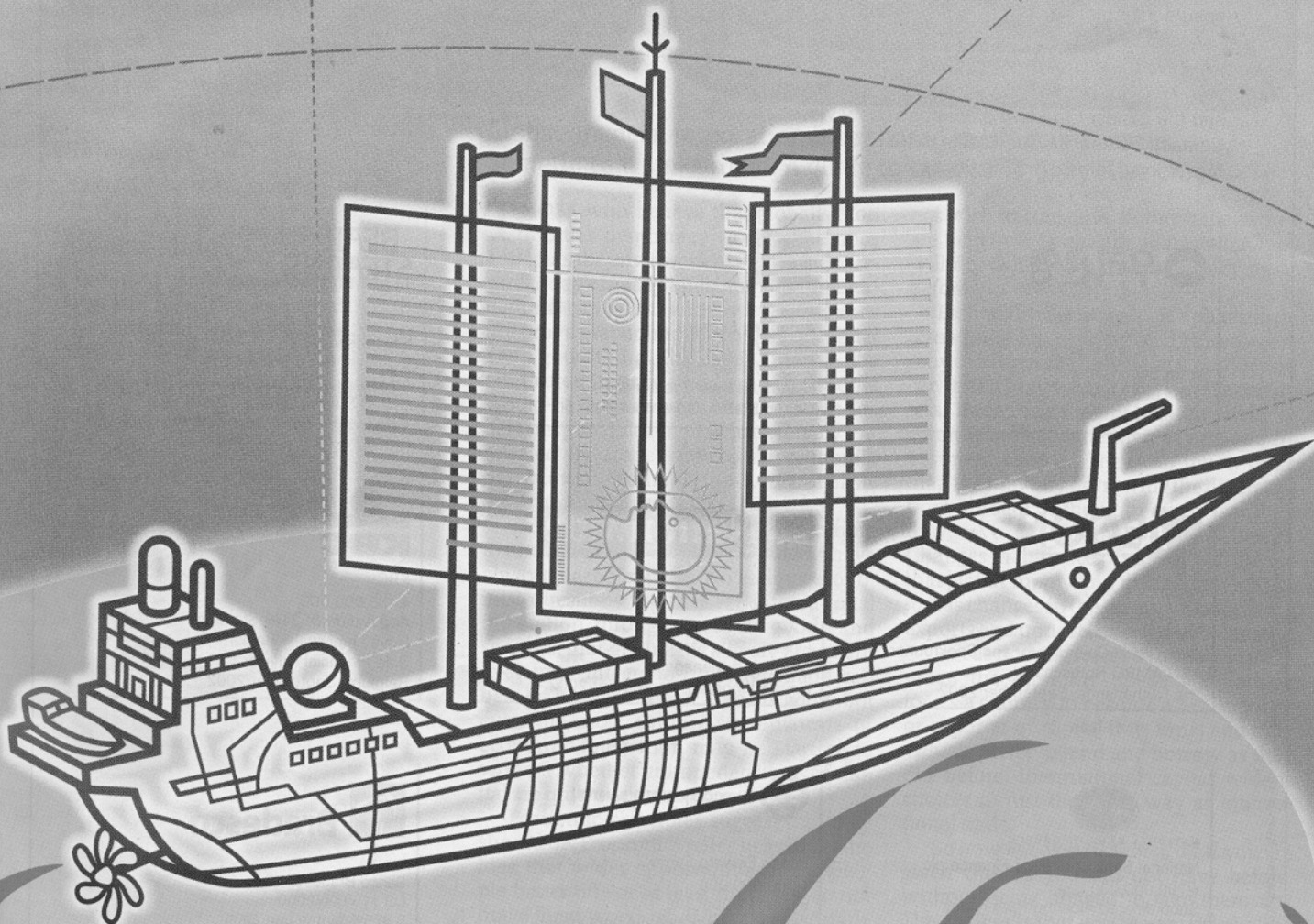


The
Economist

A cruel sea of capital

A survey of global finance | May 3rd 2003



A cruel sea of capital

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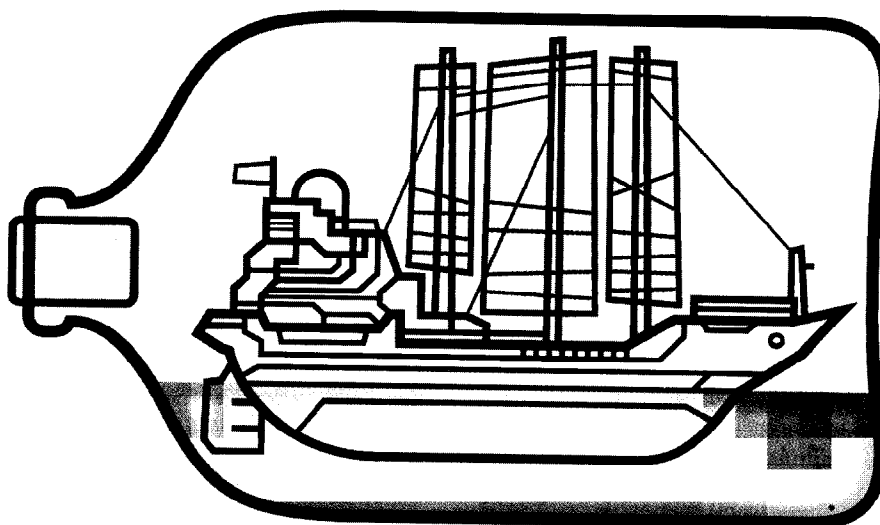
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Global financial integration is supposed to lift countries up. Sometimes it sinks them. A guide to safer sailing, by Clive Crook

THOSE who believe that globalisation throttles democracy, gouges the poor and fouls the environment are bound to regard today's mostly open markets for international capital as evil. However, this does not prove that unimpeded flows of capital are a good thing. The capital market has vindicated its critics and embarrassed its would-be defenders too often of late. It has been responsible for, or at least deeply implicated in, some very costly economic breakdowns. Perhaps the anti-globalists are on to something.

Rapid globalisation has done nothing to undermine the confidence liberals have always placed in trade. No serious economist questions the case for international integration through flows of goods and services, though there is a lively argument over how integration through trade can best be brought about. Trade is good. But even the most enthusiastic advocate of economic integration may be starting to wonder whether unimpeded flows of capital are quite such a blessing.

Economic principles suggest that they should be. Economics relies heavily on the idea that wider opportunities make people better off—or at least that they do not make them worse off. Whatever else trade does, it widens opportunities. When trade barriers come down, people on each side have an opportunity lacking in a closed economy. They can decide to consume goods that they have not produced, and pay for them by producing goods they do

not wish to consume. If they believe they are better off as a result, that is what they will do. Otherwise, they will carry on as before.

Essentially the same logic applies to international finance. Just as a closed economy can consume only what it produces, it can invest only what it saves—no more, no less. Trade in capital makes it possible for countries to separate their saving and investment choices. They can invest more than they save by borrowing the difference from abroad; or they can invest less than they save by lending out the surplus. Changes in the price of capital will ensure that global supply and demand match up, just as changes in the prices of goods bring exports and imports into global balance.

Just as nothing forces a country to trade when the economy opens up, nothing forces a country to become a net importer or exporter of capital if its firms and individuals prefer to lend and borrow as they did before. International capital widens choices in just the same way as international trade.

So how can you be worse off if you are given choices you did not have before, without being obliged to take them up? The answer is that you may make choices you come to regret. Experience suggests that even within the borders of a single economy, trade in capital is far more prone to mistakes than trade in goods or services—though why this should be so is not immediately obvious. And if domestic ►

trade in capital is more error-prone than domestic trade in goods, then international trade in capital is even worse. This perhaps is easier to understand: take the mistakes that get made in a domestic context, then multiply them by ignorance due to distance and exchange-rate risk.

The result is plain enough: recurring financial calamity; sovereign debt default; capital flight; currency crisis; bank failure; stockmarket crash. And the harm is by no means confined to the people who made the mistakes, or to the finance industry at large. Financial collapses have an unmatched capacity for projecting their effects right across the domestic economy, and in the worst cases far beyond that, across the region and even across the world.

Even if there were no doubt that the gains from trade in capital are large—on a par with the gains from trade in goods and services—the costs incurred in recent financial emergencies would still give one pause. Financial crises of the sort that hit Latin America in the 1980s, Mexico in 1994 or East Asia in 1997-98 cause recessions equivalent to years of growth forgone. The 1980s were aptly called Latin America's "lost decade". Argentina and Brazil, to name but two, are even now struggling, respectively, with an exceptionally severe recession and the threat of a new financial collapse. Financial distress is a salient ingredient in Japan's endless economic difficulties, in Europe's current slowdown, in the fragility of America's economic recovery. And if things grow suddenly worse in any of these places, finance will spread the damage far and wide.

So trade in capital is different from trade in goods and services in two main ways: in the scope for getting things wrong, and in the punishment that follows. The first is great and the second is fearsome. It is enough to make a good liberal stop and think.

We all make mistakes

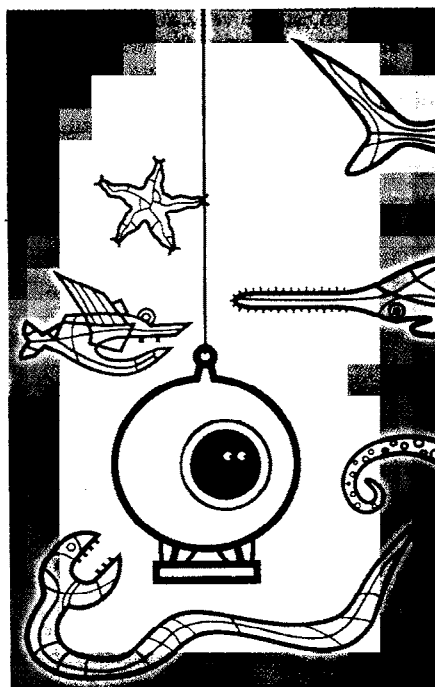
What makes finance so prone to error? Financial markets are asset markets: that is, they are markets for streams of payments spread out over time. (Many goods and some services have an extended time dimension too. By definition, the more this is true, the more such goods and services behave like assets. That is why the market for houses behaves a lot like the market for corporate bonds and not much like the market for biscuits.) When you buy an asset you are gambling on the future. Small changes in beliefs about the future can

have a surprisingly large effect on the value of the assets concerned.

The numbers can seem outlandish, but it is only a matter of the arithmetical relationship between present value, compound interest and future value. Pricing a company share, for instance, involves several variables, but on plausible assumptions an improvement of just one percentage point in the expected growth of a company's earnings could easily justify a rise of 25% in its share price.

In other words, because asset prices are bets on a distant and uncertain future, they are inherently volatile. Moreover, investors tend to deal with uncertainty in ways that aggravate the problem. If information about underlying value is absent or obscure, they are likely to become preoccupied with the views of other investors. Sometimes, maybe usually, this is a process that uncovers new information and disperses it. Now and then, however, it degenerates into crowd hysteria.

In extreme cases, the views of other investors are taken seriously even when flatly contradicted by such facts as may be available. That was certainly true during the later stages of the dotcom bubble of the 1990s, and there are countless other examples. From time to time, such mental aberrations are even dignified by being presented as "schools of thought": from "momentum investing" and "greater fool theory" to "the new economy".



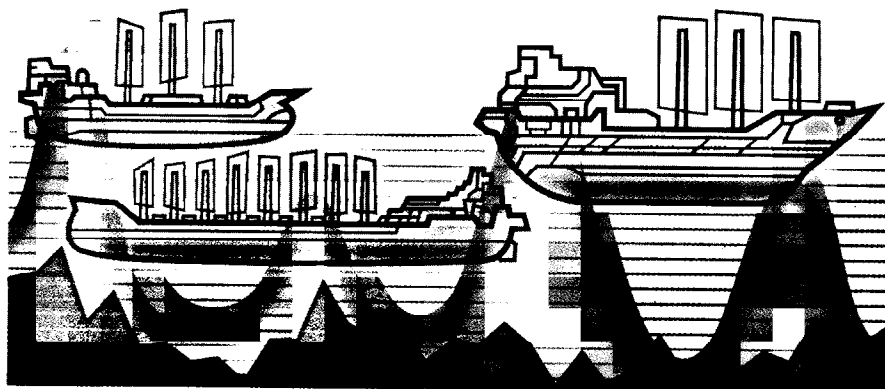
Now add to this the possibility of leverage. Thanks to capital markets, investors can place their bets on this distant and uncertain future using borrowed money. Without debt, the most you can lose is everything you have. If you can borrow, on the other hand, there is really no limit to what you can lose, because leverage allows you to punt other people's money as well as your own. Financial markets attract talented and ingenious people. A great deal of effort, it is said, goes into finding ways of pooling and reducing risk. Evidently, however, a good deal also goes into finding ever more complicated ways of building leverage on leverage, and then leveraging some more.

It has been widely noticed that going bankrupt for a few million dollars is no more painful than going bankrupt for a few thousand. This is apt to discourage prudence, and the imprudent, however talented and ingenious, make mistakes.

Debts are also a main reason why mistakes in financial markets, when they happen, can have bigger consequences than errors in an economy's less excitable parts. Losses may cascade across a series of lenders, many of which may not even have realised that they were exposed to the risk. A surprise that is big enough and bad enough may perturb the mood of self-justifying expectations that had up to then been propping valuations across an entire class of investments, and at worst across the economy as a whole.

A particular risk is that a bank may be threatened with failure as a result of its losses. Banks are intrinsically fragile entities, which is why, historically, they have invested so much in the pretence of security and solidity. They promise to give depositors all their money back on demand. As soon as depositors ask a bank to make good on that pledge, the bank (which retains only a fraction of its deposits in ready cash) goes bust. Depositors at other banks may then want their money back too. And because banks provide the infrastructure of payments services in a modern economy, that comes under threat as well.

Financial volatility need not in itself be such a bad thing. Even if it causes volatility in GDP, and hence in incomes, that is not necessarily disastrous either. People have ways of protecting themselves against ups and down in their incomes. Financial markets, of course, can help them in this. Governments can help as well, with safety-nets of one sort or another and with policies that mitigate the highs and lows of the economic cycle. Unfortunately, the evi- ➤



global finance, substantial as they may be, justify the risk? The answer, as this survey will argue, is yes—but for many economies it is a close thing. Much depends, as well, on exactly what is meant by “unimpeded”.

A close-run thing

Trade in goods and services is simple: what governments need to do, through the World Trade Organisation, through this or that regional trade agreement, or best of all unilaterally, is abolish their barriers. When it comes to finance, there is no such straightforward advice. “Let capital flow where it may” is bad policy. Finance must be intelligently regulated, at home as well as internationally, in ways that ordinary commerce does not require. When capital flows are liberalised, it needs to be done cautiously and within prudent limits. To that extent, global finance must indeed be impeded.

Governments and their advisers are a long way from understanding how this should ideally be done, let alone from

putting any such understanding into practice. There is no detailed consensus on the right approach to international financial regulation, any more than there is on the domestic sort: there is plenty of activity, but for the most part it is co-operation without conviction.

The risks of international finance need to be frankly acknowledged, and then reduced so far as possible. That means weighing the costs and benefits of different kinds of capital mobility, and setting policies accordingly. It means abandoning certain orthodoxies of international economic policy. The danger cannot be eliminated altogether, but the remaining risk is worth taking because the potential gains from international capital flows are large, especially for the world's poor countries.

To ignore that potential would be an even greater mistake than to liberalise recklessly. The global capital market is a treacherous aid to economic growth, but in the end, above all for the poor, an indispensable one. ■

Catching the tide

Why does so little capital flow from rich countries to poor?

SUPPOSE capital were bottled up in individual countries, not free to flow from one to another. Rich economies would have lots of it. Too much, in a way: the law of diminishing returns would have set in. Poor economies, in contrast, would have less capital than they can put to good use: returns to extra capital there would be higher. Both kinds of country, and the world as a whole, would be better off if people were free to move capital from the one to the other—or so it would seem.

The poor-country capital importers would invest more and produce more. The rich-country capital exporters would invest less, but the income they lost this way would be more than outweighed by the additional income they received from investments abroad offering high returns.

This is the simple theory of international capital flows. Sometimes it works. For sustained periods during the past century or two, capital went where it was supposed to, and made a great difference to the pattern of economic development. In the last quarter of the 19th century, British capital equivalent to 5% of host-country GDP and more flowed out each year to the United States, Canada, Australia and Argentina. France and Germany were big exporters of capital too, though not quite on that scale. The flows paid for a large part of the investment undertaken in the capital-importing countries.

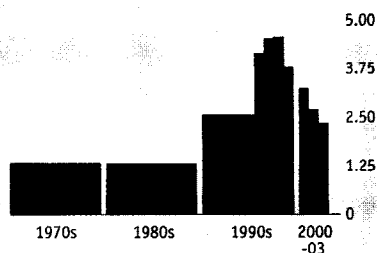
This golden age of financial globalisation ended in 1914. Global financial connections were cut by the first world war, and only briefly repaired in the immediate

aftermath. Then, for nearly half a century, from the Depression until the 1970s, international flows of private capital dwindled to almost nothing. In the 1970s, net flows of private capital to the world's poor countries amounted to a little over 1% of host-country GDP. This trickle was sufficient to finance a miserly one-twentieth of what many poor countries spend on investment (and an even smaller share of what they should be spending).

By the end of the 1970s, those meagre figures were increasing, though they still fell far short of the 19th-century boom. And the resurgence, such as it was, ended badly, in the debt crises of the 1980s. By the end of the 1990s, flows had recovered from that setback and endured two more—the Mexican devaluation of 1994 and the ►►

Go with the flow

Net private capital flows* to developing countries
% of GDP



*Long- and medium-term flows of debt, FDI and portfolio, net of repayments
Figures for 1970-95 are averaged

Source: World Bank

► East Asian debacle of 1997-98. Taking one decade with another, flows in the 1980s were about equal to flows in the 1970s; during the 1990s, they were substantially larger. By the end of the 1990s, annual flows as a proportion of developing-country GDP were some three times bigger than in the 1970s (see chart 1).

Nonetheless, measured against the apparent opportunities for productive investment in the developing countries, as well as against the flows a century earlier, they were still small. At the end of 2001 (the latest year for which figures are available) the worldwide stock of cross-border bank loans and deposits was \$9 trillion. Of that, only around \$700 billion was attributable to developing-country borrowers. The stock of global cross-border investment in securities was some \$12 trillion, of which developing-country borrowers accounted for just \$600 billion. As in the 19th century, moreover, most of the capital exported by rich countries to poor countries still travels to just a handful of recipients.

Anti-gravity

These figures belie the idea of a steady tide of capital running from rich countries to poor. On average, it is true, creditor countries are richer than debtor countries; in this sense, at least, capital does flow downwards. But there are some notable exceptions even to this broad pattern. Despite its economic slowdown, the United States continues to invest a lot while saving next to nothing: its economy draws in huge amounts of capital from abroad, and its net foreign liabilities currently stand at more than 20% of GDP.

All this raises a question. The most successful developing countries of an earlier era showed that foreign capital can make an enormous difference to their prospects for rapid development. Financial crises

notwithstanding, rich-country investors profited too. Why, in that case, does capital today not flow in much larger quantities from rich parts of the world to poor?

One reason is that capital is not the only thing which is lacking in most developing countries. Labour may be plentiful, but workers in poor countries are mostly less well educated and have less training in industrial skills than their rich-country counterparts. In many countries, property rights are insecure and the rule of law is unreliable. The economic infrastructure necessary to get the most out of new investment may not be there. Political risk may be a problem. For these and other reasons, switching capital from countries where there is plenty to countries where there appears to be a shortage yields smaller profits than one would suppose. (America's overwhelming advantages in all these respects help to explain why it attracts so much new capital, despite seeming to have more than it needs.)

Second, most developing countries do not let capital come and go freely. Blanket restrictions on the movement of capital are much rarer than they used to be, but assorted official or unofficial obstacles are still often put in the way of foreign investors. Despite measures to liberalise the capital markets in recent years, they are still far less open to cross-border finance than the typical developed economy (see chart 2).

So where the flow of international capital could do most good—in the developing countries—there is precious little of it. Does that matter? If you take the view that capital flows are more of a curse than a blessing, probably not. Yet history suggests that the most successful developing countries, at least up until the first world war, benefited enormously from foreign capital. And everybody agrees that the flow of capital from one rich country to another is wholly beneficial for both sides. Is anybody suggesting capital controls for the United States? Not even those who consider America's present rate of capital inflow worryingly high. The benefits of access to global capital markets are called into question only for poor countries.

To get an idea of what is at stake, it would be useful to have a rough estimate of the developing countries' gains from capital flows. Unfortunately, no generally agreed estimates exist. The 19th century seems too remote a guide. Careful analysis of the more recent connection, if any, between capital flows and growth in developing countries is still surprisingly sparse, though interest in the subject has

been mounting lately. As yet there are relatively few studies, far fewer than of the links between growth and trade, and the results have not settled down to anything resembling a consensus. This is partly because the expansion of rich-to-poor capital flows to significant size is, as noted earlier, a comparatively recent event.

Guessing the benefits

Two other things frustrate efforts to estimate the gains. One is that the main effects of openness to capital can be expected to push in opposing directions: access to capital ought to spur investment and growth, but at the same time it will expose an economy to additional economic turbulence which may slow it down. The net result will be difficult to uncover among all the other factors contending for influence.

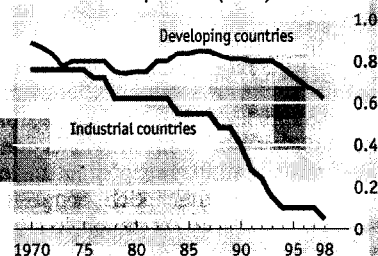
Also, "capital flows" is a broad term. It includes quite different kinds of financial transaction: bank lending, short- and long-term; investment in public or private bonds; investment in equities; direct investment in productive capacity. Each has different implications for growth on one hand and exposure to capital-market risk on the other. The gains from capital inflows are going to depend on exactly what kind of capital is flowing. Again, statistical evidence may struggle to provide answers.

Still, one may hazard a guess. According ►

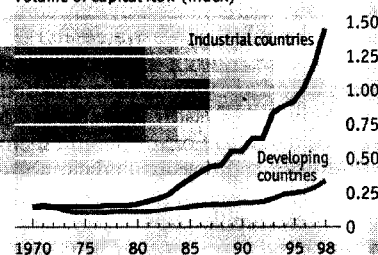
All together now

Measures of financial integration:

Restrictions on capital flow (index)



Volume of capital flow (index)



Source: "Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence", by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose. IMF, March 2003

to one recent review of the literature, by Wendy Dobson of the University of Toronto and Gary Hufbauer of the Institute for International Economics, developing countries may have gained roughly as much, overall, from access to global capital markets as from access to trade in goods and services. The authors say it is plausible to suppose that by 2000 developing countries were gaining around \$350 billion a year in additional GDP thanks to access to the global market in goods and services. As a result, developing-country GDP was about 5% higher than it would otherwise have been. Drawing on research that aims to separate the effects of different kinds of capital, they calculate that the gain up to now from even the limited access to international capital these countries have enjoyed might be about the same.

If the gains from (incomplete) capital-market integration really are as big as that, they would be worth the price of a financial crisis or two. Over the past few decades, admittedly, the world has suffered more than a few. When it did the sums in 1999, the IMF counted 64 banking crises and 79 currency crises since 1970. (That includes some double-counting, because many countries had both kinds of crisis simultaneously.) Most of these were small affairs, national rather than international in character. Over time, however, the role of international capital in spreading financial breakdown across borders has been growing. And when financial crises happen, the toll on incomes is heavy.

Ms Dobson and Mr Hufbauer have gathered estimates of the cost in lost GDP of 24 banking crises and 36 currency crises during the 1980s and 1990s. Research suggests that the calamities of the 1980s cost Latin America an average of 2.2% of GDP a year over the decade. In the 1990s East Asia's financial traumas cost the region 1.4% of GDP a year.

Within these regional averages, of course, some countries suffered much more than others. Indonesia's output, for example, fell by 14% in 1998 alone, against an earlier trend of 7% annual growth: a one-year GDP shortfall of more than 20%. Overall, though, the cost of financial crises for all emerging-market economies worked out at around 0.6% of GDP a year for the 1980s and 0.7% of GDP a year for the 1990s (see table 3). Set beside Ms Dobson's and Mr Hufbauer's estimated capital-market benefits of 5% of GDP a year, that does not seem too bad.

However, many critics of financial globalisation would challenge these num-



bers, especially so far as the benefits are concerned. And they have a surprising new ally. A new review of the empirical literature by economists at the IMF, traditionally devoted to the cause of open capital markets, finds no consensus that financial integration yields any net benefits in growth at all (even though, the Fund insists, in theory it ought to). Of 14 papers reviewed, only three find that financial integration has a positive effect; another four find that the effects are mixed; and the rest find no effect one way or the other. The IMF's review also looks at the relationship between other measures of economic well-being and different measures of econ-

omic openness. Trade improves economic welfare, according to this research. Financial integration has no significant effect.

The absence of a clear conclusion suggests two possibilities. One is that financial integration is indeed a mixed blessing: it has costs as well as benefits, making net benefits (if any) hard to spot. Second, unlike free trade, financial integration may be good for economies only if certain conditions are met. If countries meet these requirements, they gain; if not, they lose. On balance, the effects tend to cancel out. These theories are not mutually exclusive.

Split the difference

Even so, for some countries, at least, access to global capital is likely to bring advantages as well as drawbacks. And there is no need to come to an all-or-nothing judgment about capital flows. The choice is not between completely unfettered flows, and financial isolation. According to circumstances, a middle way may be best. The aim should be to reduce the costs of financial integration without casting aside such benefits as there may be.

Seeking the benefits of financial integration while suffering fewer costs is a difficult task, as the rest of this survey will explain, but by no means a hopeless one. There is little prospect of ever eliminating the risk of financial crisis, short of eliminating finance itself. But the terms of the trade-off between higher incomes (because of broadened economic opportunities) and higher risk (because of exposure to financial hazards) can be improved.

Unfortunately, developing countries face particular difficulties in striking the right balance. The combination of malfunctioning domestic finance, weak regulation and erratic economic policy is perfectly designed to get the worst out of financial openness. In countries where those failures are severe and cannot be corrected, an incautious opening of the economy to foreign capital is likely to do much more harm than good.

Reaching a modest minimum competence in regulation and economic policy is crucial for the emerging-market economies. And there is a lot of work for governments elsewhere too—very much in their own interests, not just for the sake of spurring development in the poor countries. Rich-country suppliers of finance, rich-country regulators and the international financial institutions directed by rich-country governments all need to do better if the full mutual benefits of financial globalisation are to be achieved. ■

Downside

GDP losses from banking and currency crises

	1980s	1990s
GDP loss from financial crises in emerging markets, \$bn	249	419
Asia	13	260
Latin America	207	123
Africa	15	18
Europe	na	11
Middle East	14	7
Average annual GDP loss in emerging markets, %	0.6	0.7
Asia	0.1	1.4
Latin America	2.2	0.7
Africa	0.5	0.6
Europe	na	0.1
Middle East	0.3	0.1

Source: "World Capital Markets: Challenge to the G10", by Wendy Dobson and Gary Clyde Hufbauer, Institute for International Economics

Hot and cold running money

One way of increasing the benefits of global capital while reducing the costs is to alter the mix

ARE some kinds of capital inflow better than others? On the face of it, yes. Borrowing from a bank, for example, is relatively risky. If, for example, the borrower's income falls, for whatever reason, he has no choice but to service the debt just as before, even though his capacity to do so may be less. A bank loan taken out at a floating interest rate, or denominated in foreign currency, exposes the borrower to additional risks beyond his control. Banks may call in loans, or refuse to roll over short-term credits.

At the other extreme, foreign direct investment (FDI) looks comparatively safe. In effect, the foreign investor is sharing much of the receiving country's risk. If profits should fall, so will the foreign investor's income from his investment: the cost of servicing the investment moves in step with the recipient's economic fortunes. Also, FDI is a lot more difficult to withdraw when times are hard. Investments may have to be sold at a loss, if they can be sold at all. Somewhere between bank loans and FDI in terms of risk-sharing are portfolio investments such as bonds and shares.

Again, however, there are trade-offs which make the choice more complicated than it seems. A key issue is cost: there is no something for nothing in international finance. FDI may be a safer source of capital than borrowing from a bank, but in the long run it is likely to be more expensive.

The reason is simple: in return for shouldering extra risk, investors require a bigger income. In the end, the share of profits to which FDI entitles them can be expected to pay a lot more than the interest payments due on a comparable bank loan.

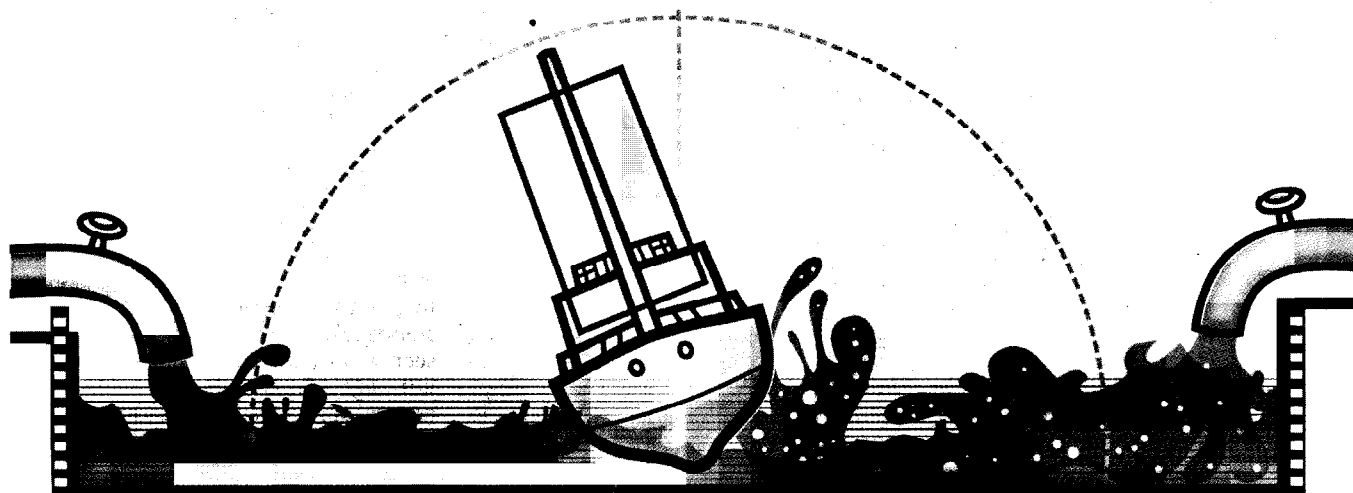
FDI has other drawbacks. It is much more difficult to arrange. Banks specialise in bridging the gap between investors and borrowers, bringing them together even though one may know nothing about the other. FDI demotes the middle-man to an advisory role at most, so the principals have more to do. Direct investment requires a close long-term relationship between the investor and the company that is invested in.

This is an advantage in some ways. FDI often brings the recipient useful technical and managerial knowledge, and vital contacts in world markets, as well as money. But an FDI partnership requires a big investment of time and effort, especially on the investor's side. This will tend to narrow the scope of FDI to large projects in relatively large recipient countries (which can offer the investor a correspondingly big market for its output). Of all the companies or activities in developing countries that could make good use of foreign capital, comparatively few are currently in a position to attract FDI.

A pity, because the economic evidence, such as it is, seems to confirm that FDI is on

balance the most desirable form of capital inflow. Recall the estimate quoted earlier for the developing countries' gains to date from openness to cross-border capital: an improvement of 5% in GDP, roughly on a par with the gains from trade. The studies which yield that number allow separate (albeit rough) estimates to be made for the respective gains from FDI, portfolio flows (bonds and equities) and bank loans. This research suggests that a rise of one percentage point in the ratio of the stock of FDI to GDP will raise GDP by 0.4%. In the decade to 2000, the ratio of FDI to GDP in the developing countries went up from 7% to 21%. That rise of 14 percentage points implies an improvement in GDP of 5.6%.

The evidence on whether portfolio investment affects growth is even more sparse than the evidence on FDI. However, the OECD's Marcelo Soto, whose work was used in deriving the FDI estimate, has looked at both. He found that, within the total of portfolio flows, equity flows have an even bigger positive effect on GDP than FDI, an admittedly strange result. Conversely, bond flows actually have a negative effect. Averaging the two, with a 60% weighting for bonds (to reflect the mix within the portfolio-flows total), suggests an improvement of 0.2% in GDP for each one-point rise in the ratio of portfolio capital to GDP. Between 1990 and 2000, the ratio of portfolio capital to GDP in the de- ➤



▶ developing countries rose from 8% to 14%, implying an improvement in GDP of 1.2%.

According to the same research, bank debt is the one to avoid. It is estimated to reduce GDP by between 0.2% (Mr Soto's figure for loans) and 0.4% (trade-related credits) for every rise of one point in the ratio of bank debt to GDP. The developing countries' stock of foreign bank loans and trade credits increased from 30% of GDP in 1990 to 37% in 2000. That implies a fall in GDP of around 2%.

It just so happens

At best, these figures should be regarded as only a rough guide to orders of magnitude. Nonetheless, they seem to support a preference for FDI over portfolio flows, and a strong preference for either of these over bank-debt flows.

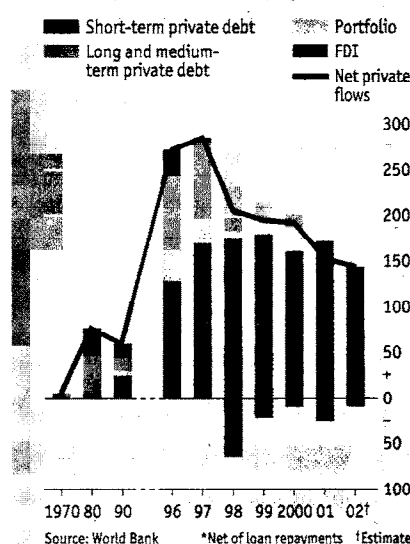
Recent years have seen a dramatic shift in the composition of capital flows to the emerging-market economies. In light of the evidence on the advantages of different kinds of capital, the change looks like one for the better. Bank lending has fallen sharply. Portfolio investment (bonds and equities) has gone up. And FDI has soared, despite the difficulties in expanding it as quickly as many countries would wish.

In 1980, flows of short-term debt to emerging-market economies amounted to \$30 billion, net of repayments. In 1990, the figure was \$15 billion. From 1998, flows of short-term debt turned negative; that is, repayments and interest exceeded new loans. FDI inflows moved sharply in the opposite direction: from \$5 billion in 1980 to \$24 billion in 1990 and \$160 billion in 2000. Net portfolio investment has increased too, from about zero in 1980 to \$26 billion in 2000 (see chart 4).

A variety of factors lie behind this changing pattern. Bitter experience, culminating in the East Asian debacle, has curbed the banks' own appetite for conventional cross-border lending, though perhaps only temporarily. Attitudes have also changed in many of the developing countries. In some of them, financial liberalisation has opened domestic securities markets to foreigners for the first time. In others, access may not yet be free but is at least easier than before. And attitudes to inward direct investment have undergone a transformation. Even countries such as India, which for decades set its face against foreign ownership of local assets, are vying with each other to draw foreign investors in. China's remarkable growth during recent years, fuelled in part by its success in attracting FDI, has not gone unnoticed.

The rise of FDI

Private capital flows* to developing countries, \$bn



Even if economic policy in industrial and emerging-market countries did nothing further to alter the mix, the trend towards greater flows of FDI and equity finance seems likely to continue. This is not because the lessons from the financial crises of the 1990s have been taken to heart: financial markets have short memories. It is because economic development itself seems to favour this kind of finance.

As the developing countries become more prosperous, their financial and legal systems will become more sophisticated. FDI opportunities will become easier to find and exploit, and domestic financial markets will converge on the standards of depth and organisation familiar in the rich West. As domestic banking systems mature, moreover, they will be able to meet more of the financial needs so far satisfied by bank borrowing across borders. With economic growth and intensifying globalisation, every kind of financial flow might well continue to expand. But the mix of capital types, left to itself, is likely to drift gradually in the right direction.

Faster, faster

Ought governments to be satisfied with that, or should they try to accelerate this recent trend? The answer is that they should hurry it up. Some suggestions follow as to how they might do it. But first a word of caution: intervention of this kind needs to be done rather carefully.

If different kinds of capital were a close substitute for one another, there would be

little need to hesitate in trying to improve the mix. Policy could aim to reduce cross-border bank flows and increase FDI, say; the expanded FDI would meet all the needs satisfied up to now by cross-border bank finance; capital flows would be safer, and nobody (except the banks) would be any the worse off. The trouble is that different kinds of capital cannot stand in for each other in this way. Many of the borrowers in developing countries that could put foreign capital to good use lack access to FDI, or to equity finance for that matter, and will for the foreseeable future. A strong push against cross-border bank debt could leave most such borrowers stranded. Risky capital from banks may be the only kind they can get.

This danger will be especially great in the poorest, worst-governed countries. Recall that FDI and cross-border equity finance are safer for the borrowing country because the investor shoulders more of the financial risk. In backward countries, foreign investors may simply refuse to do that. Legal systems may offer little or no protection against breach of contract, expropriation or outright theft. Corruption too is often an issue. In such circumstances, a western company with a reputation to lose will think twice before entering into a close economic partnership. To be sure, bank lending to such countries is hardly to be recommended either—but it may be that or nothing. Ruling out bank lending altogether is going to make some worthy borrowers worse off.

All or nothing?

Another risk is that in trying too hard to discourage one kind of capital, governments may inadvertently discourage others too. Maybe cross-border bank finance goes hand in hand with cross-border equity finance and with FDI. Discourage the banks, and far from seeing FDI and equity finance rise, you may see them fall, again leaving the borrowing countries worse off.

On the whole, though, the evidence on these interconnections is encouraging. It certainly does not seem to rule out cautious efforts at reforms to improve the mix. Within domestic financial systems, different aspects of financial development tend to go forward together. Bank finance and stockmarket development, for instance, seem to be closely associated. But there is little sign that cross-border bank finance has any particular significance in this. Certainly, economic policy needs to nurture efficient domestic banking: for its own sake, and also because otherwise equity ▶▶

markets and other aspects of financial deepening may be held back. But so long as governments do not discourage cross-border bank finance in a way that also discourages domestic bank finance, the effects on FDI and securities markets are likely to be slight.

So far as substitution of one kind of capital for another is concerned, the price to be paid for discouraging cross-border bank lending seems affordable. Other forms of capital are unlikely to expand to fill all of the gap, but they will expand to fill most of it—especially if the rules are drawn up to discourage only those forms of bank finance that are particularly hazardous for poor-country borrowers.

If the rules concentrate on discouraging short-term lending, for instance, the resulting gap can be filled not just by additional FDI and portfolio investment, but also by additional long-term loans—not as risky as

short-term loans. In 1991 Chile imposed an implicit tax on inflows of short-term capital to reduce the aggregate inflow. In that, the policy failed: the overall flow was not much changed. But studies conclude that the tax did alter the pattern of inflows, shifting it away from short-term debt. That was a useful, albeit accidental, discovery.

Bear in mind, also, that in making the global capital market a safer place, the policy-reform agenda goes far beyond the extent to which developing countries should encourage or discourage particular sorts of inflow. It requires changes in a broader set of policies, aimed at promoting an efficient and well-balanced domestic financial system. That in itself will help speed the right kind of inflows; and without it, even the right kind of inflows would be little use.

Rich-country policies need to be looked at as well. The mistakes that led to the financial crises of the 1980s and 1990s were

made by rich-country financial institutions under the supervision of rich-country regulators. And finally there is the multinational dimension: rich countries and poor countries alike need to examine the “architecture” of international finance, and see what kind of additional work—extensions, embellishments or strengthened foundations—may be needed. Are multinational bodies such as the IMF doing all they can to prevent crises or, if they happen, to manage them competently?

The financial upsets of the past two decades, and especially the East Asian crisis of the late 1990s, have yielded a mass of new information and spurred a great deal of activity under each of these headings. Under its own steam, the global capital market seems to have been moving lately to a safer and more productive mode of operation. Here and there, better policy can help to move that process along. ■

The trouble with banks

Nobody loves them, everybody needs them

BANKS have proved themselves to be the most hazardous economic institutions known to man. Breakdowns in banking lie at the centre of most financial crises. And banks are unusually effective at spreading financial distress, once it starts, from one place to another. It is tempting to conclude that banks should simply be abolished. Unfortunately, that is unlikely to be possible. Banks seem to be necessary.

To see why, consider the job that any financial system has to do. It has to bring willing lenders and willing borrowers together. One way or another, this involves processing information. Two kinds of problem arise. First, the lender needs to know whether a would-be borrower is a good risk. To complicate matters, the keener the borrower—and the higher the interest rate he is willing to pay on the loan—the more likely he is to be a bad risk. This is called adverse selection: the most eager borrowers will be the least desirable, making lenders less willing to lend. The possibility of adverse selection inhibits productive lending and borrowing.

The other problem that financial systems encounter in processing information is moral hazard. Once a borrower has his loan, he may try to cheat. In investing the money, the most he can lose is the amount

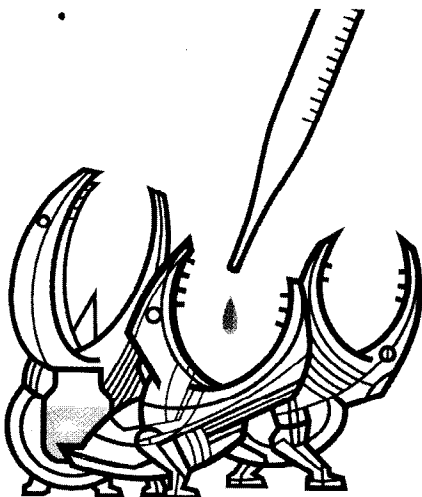
of the loan. But he may calculate that the greater the risk he takes with the money, the higher his chances of doing very well. Because his losses are capped, he is encouraged to take a bigger risk with his investment than he otherwise would.

Moral hazard becomes acute if the borrower expects to lose the value of his investment anyway. In that case he has nothing further to lose by taking a much bigger risk in the hope of turning his for-

tures around. If this “gamble on redemption” works, he keeps all the proceeds after the loan is repaid, but the lender gets no extra return. If the gamble fails, the borrower is no worse off than if he had acted prudently. Moral hazard also takes more obvious forms: some borrowers will be tempted simply to steal the money, or waste it, or otherwise do things that make it less likely that the lender will be repaid. Lenders deal with moral hazard in the same way they deal with adverse selection—by lending less than if they had all the information they needed.

This is where banks come in. They are specialists in dealing with adverse selection and moral hazard, which is why their role in financial systems everywhere is so central. They develop expertise in knowing what questions to ask borrowers seeking loans; indeed, they will already know a good deal about them if the would-be borrowers are existing customers. This allows them to screen out many of the bad risks. Access to information also makes it possible to curb moral hazard. Banks can monitor what their borrowers are up to; they can set restrictions on what the money is to be used for, and enforce them by threatening to call in loans or withhold new ones.

Could all this not be done by financial ►



markets, at arm's length? Up to a point, but banks do have the edge. They are more likely to know a lot about the borrower to begin with. Moreover, they keep all the benefits of effective appraisal and monitoring to themselves, so they are willing to bear the risk.

Compare this with a loan that takes the form of a bond purchase. Suppose that one investor has managed to gather the information needed to curb adverse selection and moral hazard, and on that basis buys a bond from the would-be borrower. Other lenders will be able to see this public transaction taking place, and will be able to buy bonds too, profiting from the first investor's outlay on appraisal and monitoring at no cost to themselves. Because of this open invitation to free-riding, a market-based investor will not want to spend much on appraisal and monitoring: unlike the bank lender, whose transactions are private, he cannot keep the benefits to himself. Everybody will try to take advantage of everybody else's efforts.

As a result, there will be too little appraisal and monitoring, and the problems of adverse selection and moral hazard will be much less well controlled. The cost of lending is driven up; financial activity, and output and incomes in the wider economy, will all be lower. This is why banks are necessary.

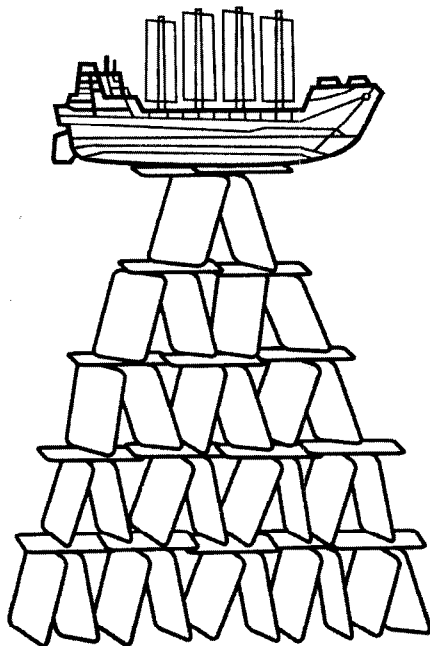
Make that "banks"

Banks may be necessary because of their core financial functions, but just how widely the business of banking ought to be spread is more debatable. Some economies' financial systems rely on bank finance far more than others. And the nature of banking is changing fast almost everywhere. A core of traditional banking—deposit-taking and straightforward commercial lending—may be indispensable, but how much of it does a successful economy need? In many countries, traditional banking represents a diminishing part of what modern banks do.

Economists have long theorised about the relative merits of bank-based finance and market-based finance. For years it was taken for granted that financial systems dominated by banks, such as Germany's and Japan's, were better at mobilising capital and channelling it to the best uses than systems such as the United States' and Britain's, which give financial markets a larger role. This was especially true, it was believed, of economies at an early stage of development, where the information-gathering advantages of banks were cru-

cially important. Believers in market-based systems emphasised the advantages on the other side, including improvements in the governance of companies fostered by an active market in corporate control.

By the end of the 1990s these supposed advantages of bank-based systems seemed rather less compelling. Japan (especially) and Germany were achieving a less-than-stellar economic performance, in stark contrast to America's remarkable success during the decade. The current economic consensus, underpinned by new research, is not that one system is necessarily better than the other, but that either can work fine so long as certain condi-



tions are met.

The critical factor turns out to be the efficiency of the domestic legal system. If that is working well, a financial system can deliver the necessary array of financial services regardless of whether it is based mainly on banks or mainly on markets. Moreover, the evidence confirms that financial development—measured by the breadth of financial services, again regardless of whether they are delivered by banks or markets—plainly promotes economic growth.

So the modern findings on financial structure, even though they have retreated from the earlier idea that bank-based systems work best, offer no reason to jump to the opposite conclusion. Get the legal fun-

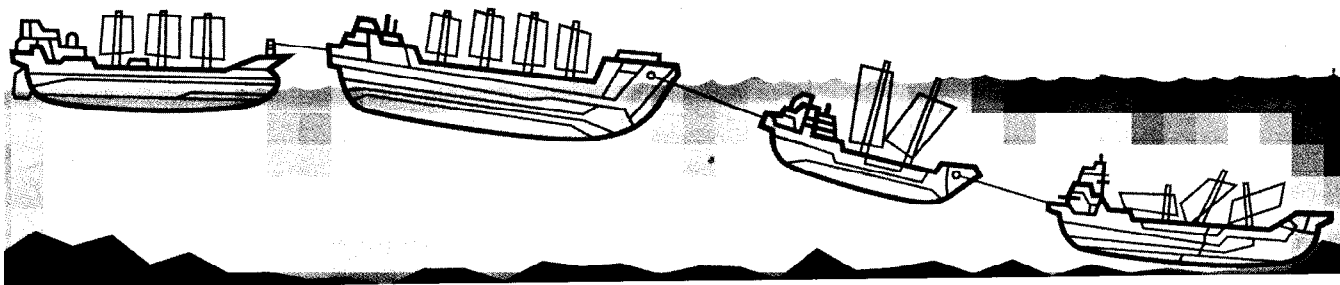
damentals right, and banks are generally no better or worse than markets in allocating capital and promoting growth.

In any case, financial innovation is eroding the distinction. Over the past 20 years, deregulation, competition and technological progress have transformed banking worldwide. In a sense, banks have become increasingly market-based in the way they conduct their own business. The models are converging. Nowadays banks bundle assets (loans) into securities and trade them; increasingly, they earn income from fees as well as from interest. The once-sharp distinctions between commercial and investment banking, portfolio management and insurance are blurring. And the use of financial derivatives—in yet another new set of financial markets—is altering the way banks manage risk.

These trends are welcome in some respects and worrying in others. Banks can achieve a much finer degree of control over financial risk than before. In principle, this should improve the terms of the trade-off between risk and return across the entire economy, making it possible for an investor to achieve a given return at lower risk, or to earn a higher return for assuming the same risk as before.

But there are two snags. One is the sheer complexity of the positions that modern financial derivatives allow banks to create. Often, according to practitioners themselves, this outruns the ability of the institutions concerned to manage their risks. The other problem is much deeper. Sophisticated derivatives ought to help the economy find a better balance of risk and return, with the risks more accurately allocated to those who are willing and able to bear them. But what if banks are somehow predisposed to take on more risk than they should? Innovations that allow banks to gamble bigger sums would then appear in quite a different light.

This is exactly what modern financial instruments do allow. Leverage—increasing the likely gain or loss from an investment of a given size—is the salient feature of many derivatives. Buying an option to acquire shares in a company, for instance, is equivalent to buying a larger number of actual shares using borrowed money. Selling such an option can expose the seller to potentially unlimited losses. An increasingly bewildering array of complex derivatives make it possible to create enormous leverage. If banks for some reason tend to take on more risk than they should, financial innovation has unquestionably made ▶▶



► this easier to arrange—and harder for supervisors, or even the bank's own managers, to monitor.

Unfortunately, banks do have a reason to take on more risk than they should. The reason, paradoxically, is the safety net that governments put in place to prevent bank failures. By trying to make banks safer, governments give banks the means and the motive to behave recklessly.

Fond of a flutter

Banks are intrinsically fragile. They borrow from depositors with a promise to repay in full and on demand, and then mostly invest those deposits in longer-term loans. If depositors all suddenly decide to withdraw their money at once, as their contract with the bank entitles them to, the bank cannot meet the demand for funds. It will fail.

Depositors might be induced to withdraw their money by fear that the bank might be in trouble. Once this fear starts, it becomes self-fulfilling, because if there is any doubt about the bank's safety, depositors have every reason to withdraw their cash: they lose nothing by doing so. If one bank is perceived to be in danger, other banks are likely to come under suspicion too. Bank runs, once they start, tend to spread. Note that equity investors who fear a collapse in share prices face different incentives. As concern mounts, equity prices fall immediately, which makes it less attractive to sell. In a stockmarket, therefore, the price decline is somewhat self-limiting. Conversely, once a bank scare begins, there is no fall in price to deter further withdrawals. Deposits remain redeemable at par until the bank locks its doors.

At different points during the course of the 20th century, rich-country governments decided that banks were too vulnerable to this danger. They were also aware that bank failures could cause damage not just to depositors too slow to get their money out, but much more widely across the economy. Banks are needed, after all, not just for intermediation between lenders and borrowers but also to oil the wheels of everyday commerce. If the banking system collapses, the infrastructure for making and receiving payments collapses too, and the rest of the economy will follow close behind.

The solution, governments decided, was to assure depositors that banks were sound, by promising to step in themselves if need be. They promised to supply a safety net, by arranging for deposits to be insured and in other ways. If depositors could be persuaded that their savings were safe, there would be no danger of a bank run and banks would not fail—or would fail only rarely, and would not take the rest of the system down with them when they did. Confidence in the banks would be self-fulfilling, in just the same way as in the absence of a safety net lack of confidence is self-fulfilling. The cost of providing insurance would therefore be modest.

Recall that banks exist because they are an answer to the problem of moral hazard: they can monitor borrowers to make sure that the funds are not stolen or wasted. But who monitors the monitors? Banks are borrowers too: they borrow from depositors. What stops banks from wasting the money they borrow? Partly, the fact that depositors will not trust their money to an institution that they suspect will be reckless with it: they will place deposits only with banks that they judge to be safe.

Once governments arrange for deposits to be insured, however, there is no longer any reason for depositors to worry about the safety of their bank. They will get their money back anyway. So banks will be able to take bigger chances with the money they lend. They will be able to lend to bad risks, charging more in interest and therefore earning bigger profits. Higher lending rates will allow them to pay depositors more too, enabling them to bid for a bigger share of the market. So once depositors stop caring about the soundness of their banks, bad banking quickly crowds out good.

Enter the regulator

Governments have long understood this. Their solution is to monitor the banks themselves. The quid pro quo for deposit insurance—itsself absolutely necessary, they say, to guard against runs—is careful supervision. Require the banks to keep a certain minimum proportion of their assets in reserve, monitor their lending policies, place restrictions on the businesses they can enter, and so forth. Having lifted the burden of bank supervision from depositors, there is only one possible course:

nationalise it.

This all seems logical enough, but the success of the policy has been mixed at best. Banking and financial crises keep happening. And there is good specific evidence that deposit insurance contributes to financial instability, especially in developing countries. A recent study by Edward Kane of Boston College and Asli Demirguc-Kunt of the World Bank shows that where effective bank regulation is lacking (as it is in many developing countries), deposit insurance of the wrong kind does more harm than good. The wrong kind means, in particular, that it is too generous in its coverage; too well-funded, with reserves explicitly set aside for repayment of losses; and run by government officials rather than by the private sector.

This helps to explain why banks have been so deeply implicated in the financial crises of recent years, as the next section will explain. An exaggerated appetite for risk has been part of the problem. And as banks have become more sophisticated, even the best regulators have found it increasingly difficult to keep up.

So if depositors were responsible for supervision instead, would they do better? At first sight, professional, highly-trained regulators seem a more likely bet than ordinary depositors. The trouble is that regulators have allowed and even encouraged the banks to become more "efficient"—lending ever more, against the backing of a diminishing base of capital. Depositors acting on their own behalf would probably have resisted that trend and insisted on a more conservative and less "efficient" style of banking, which nonetheless had the considerable advantage of exposing their deposits to less risk.

Be that as it may, moral hazard, which banks were invented to tame, has now become one of the chief weaknesses in the international financial system. In response, governments and regulators have been trying to push more of the burden of supervision back to depositors and other parts of the private sector, without arousing fears of bank failure or otherwise destabilising the existing system. This is an extraordinarily difficult balancing act. The central role of banks in most, if not all, of the recent big financial crises in developing countries underlines just how difficult—and how important. ■

Sudden storms

Financial crises don't come from nowhere. With effort and luck, some can be avoided

ONE way to improve the capital-flows trade-off—to combine more economic growth with less financial instability—would be to avoid at least some of the financial crises that might otherwise come along. But are they avoidable? They happen so often that it is natural to think that capital mobility and financial distress are inseparable: if a country wants the first, it will have to put up with the second. There is some truth in this. Access to more capital makes bigger crises feasible; every now and then, somewhere in the world, one is going to happen.

Is this because the same mistakes are made again and again, or is each crisis unique? The answer is yes to both: each crisis is unique, and the same mistakes are made again and again. However different the precise circumstances may be in each case, most of the scores of financial crisis seen in the past few decades do have certain central features in common. This is encouraging. Understanding these features and taking steps to deal with them could increase the safety of the global financial system without denying the developing countries the capital they need to grow quickly.

Banks are almost always deeply implicated when a financial crisis occurs—and banking crises are anything but rare (see map). Given their role at the centre of any market-based financial system, it could hardly be otherwise. International bank

flows, which declined so sharply during the 1990s, can still leave a country financially much more vulnerable than the figures suggest, because bank flows are so much more volatile than other kinds. Bank capital can switch quickly from inflow to outflow, so movements that seem small in absolute terms can exercise disproportionate influence.

Two kinds of banking weakness need to be distinguished: dangers specific to the borrowing country where the crisis starts, and risks that are due to capital moving across borders. As the crisis unfolds, these two interact. And the trouble often starts with financial liberalisation, a process that may aggravate both kinds of weakness. Talk about the perils of liberalisation makes some economic liberals uncomfortable, though financial economists, including many with strong pro-market leanings, have been pointing to the dangers of badly handled liberalisation for decades.

Falling standards

Every study of the East Asian crisis of the late 1990s has drawn attention to lax lending standards in the crisis countries. A lending boom preceded the breakdowns, and in each country most of the money went into risky assets such as property and equities rather than into productive investment. In Thailand, Indonesia and Malaysia the stock of lending for property ac-

counted for as much as 40% of all lending before the crisis struck. Creditors were therefore unusually exposed to certain kinds of risk. Higher interest rates, for instance, would lower the value of the assets against which they had lent, at the same time as making some of their loans non-performing.

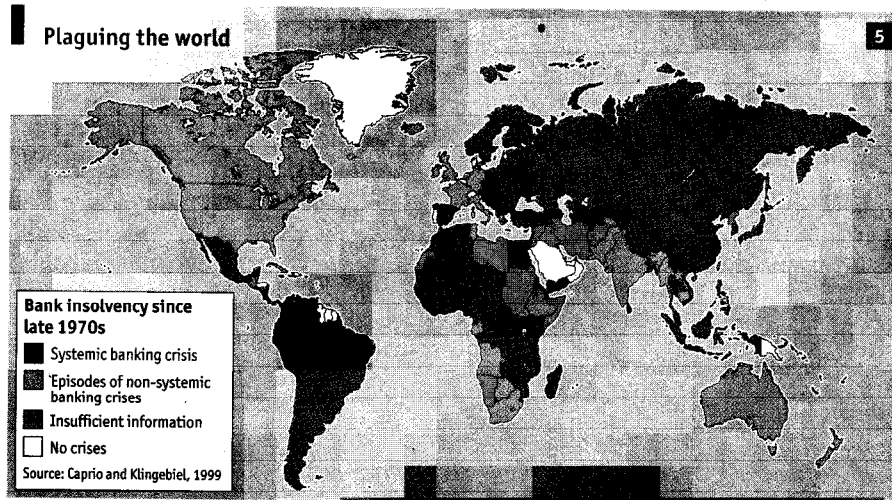
Government involvement in many of the regions' banking systems made matters worse. Ministries urged banks to lend to specific sectors or firms with little regard for creditworthiness. "Connected lending"—that is, lending to the banks' own proprietors or to affiliated businesses—was tolerated or even encouraged. Ordinary standards of prudent loan appraisal were set aside.

Banks often lacked the resources, human and technological, to apply such standards in the first place. Their lending officers and risk-management systems were stretched beyond the limit of their competence by the sheer volume of business. The same was true of the bank supervisors' resources, such as they were. Not only did the banking authorities lack the skills and the manpower to do an effective job, but they were also usually under the thumb of ministries that were reluctant to see lending curtailed.

"Forbearance" was the rule—meaning permission to keep lending until the problems went away, and to hide the evidence in the meantime. Bad loans were "evergreened": failing borrowers were allowed to service their debt with new loans. Accounting rules allowed such practices to be concealed. Nearly all of the crisis countries turned out to have had vastly greater volumes of non-performing loans on their financial institutions' books than the official figures admitted at the time. The official figure for South Korea's non-performing loans in 1996 was less than 1% of all loans—between one-tenth and one-twentieth of the true position.

In addition to weakly regulated banks, most of the crisis countries had, in effect, virtually unregulated quasi-banks operating alongside. Thailand's finance companies are the most notorious example. South Korea had its "merchant banks": owned by the country's conglomerates, ▶▶

Plaguing the world



► and more or less unregulated, they were at the forefront of credit expansion and of borrowing abroad. Indeed, the government allowed these ex-finance companies to borrow abroad only if the debt was short-term.

All of this was familiar from earlier financial breakdowns, looking back to the 1960s and before. Paradoxically, one of the least familiar aspects of the East Asian crisis, which helps to explain both its severity and the shock it caused around the world, is that many other aspects of economic policy were being handled well, and that the countries concerned seemed in most respects to be thriving.

In fact, East Asia was an extraordinary success story. Investors had every reason to feel confident. Even fiscal policy was mostly under control, which in developing countries is unusual. In a perverted way, it added to the financial danger. Investors believed that if banks and finance companies should fail, governments would be there to sort things out. The record showed that they were competent, and suggested that they had untapped fiscal resources in reserve.

The countries' success added to the dangers in another way: foreign capital was all the more readily drawn in. The sheer volume of additional inflows compounded the difficulties of monitoring and supervision. It added to the mood of optimism, so standards were relaxed still further. And it introduced the exchange rate as a new and potentially destabilising factor. Foreign inflows, while they lasted, supported the local currencies and added

to the feeling that all was well. Governments, moreover, had promised to peg their currencies against the dollar; again, the markets assumed that they meant it, and that they knew what they were doing.

This sort of activity is strongly self-sustaining. While a bubble is inflating, reckless lending seems merely bold, and appropriately well-rewarded. Deteriorating credit quality is easy to conceal so long as the price of property and other assets offered as collateral is going up. The growth in lending fuels demand, so economic growth stays high as well. That reinforces the government's reputation for competence, so the boom continues.

Overborrowing syndrome

It is easy to see how this cycle of excess gets out of hand, but what starts it in the first place? Any news that spurs a rush of optimism can get things going. One potential catalyst is financial liberalisation, the very thing that first opens the credit taps. This has been known for decades. A classic text on development finance, by Ronald McKinnon of Stanford University, spelled out the dangers exactly 30 years ago.

A later volume of Mr McKinnon's again drew attention to the risks. Published six years before the crisis of 1997-98, it recounted South Korea's previous experience with overborrowing in the mid-1960s. Starting in 1965, financial and trade liberalisation had stimulated South Korea's growth, prompting a fundamental reappraisal of the country's prospects by foreign investors (not long before, economists had compared South Korea's pros-

pects unfavourably with the North's). Liberalisation allowed capital to rush in, but the surge was too great; it forced inflation up and left the country struggling with the problem until the early 1980s.

Having started, and grown bigger, why does the bubble eventually burst? All it takes is a shift in perceptions, reversing the one that started it all off. After a few years of overborrowing, balance sheets start to look stretched. At some point, borrowers begin to think enough is enough. Here and there, asset sales begin as firms try to restore financial ratios to something closer to normal. Prices stop rising and then start falling. Inflows of capital slow and the currency comes under pressure.

The central bank would like to defend the currency by raising interest rates, but finds it cannot because the weakness of the banks has suddenly become clear. All at once the abyss opens up, and there is a stampede to get away from it. Panic and forced selling accelerate the decline in property and equity prices into a crash. The government's reputation for competence tanks. As capital flees, pressures on the currency force it to give way. All the camouflaged gambles now stand revealed as irretrievable losses. Demand collapses and the economy sinks into recession.

In the middle phase, while the bubble is inflating, multiple layers of moral hazard are in play. Domestic lenders are not effectively supervised either by regulators or (thanks to explicit and implicit deposit protection) by the markets. Foreign lenders likewise perform their death-defying feats over a safety net extended by their home ►



governments—with some additional assurance of protection from borrowing-country governments and, should things turn really bad, from the IMF.

What little discipline markets might supply under these circumstances is undone by lack of information. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts. The promise to defend the currency creates a kind of moral hazard too: an exaggerated sense of safety, leading people to do things which they would otherwise regard as too risky or too costly.

Looking back at the beginning of the 1990s, with the East Asian debacle yet to come, Mr McKinnon put it like this:

[We] know that in any purely private capital market each individual borrower faces an upward-sloping supply curve for finance. That is not really a distortion. The more that is borrowed, the riskier the loan gets at the margin. The upward-sloping supply curve imposed by private lenders accurately reflects the increasing riskiness of the private borrower as he increases his exposure.

Consider instead the world of the 1970s and 1980s, where governments guarantee all credit flows. The host government in the borrowing country guarantees private foreign credits, either officially or unofficially. In the lending countries we have official export-import banks and deposit insurance for the commercial banks. Consequently, the normal upward-sloping supply curve for finance did not face individual private borrowers in the third world during these two decades of huge accumulation of external debts. Because of the government guarantees that were involved, they could borrow at a virtually flat rate of interest.

Exactly the same thing happened all over again in the 1990s, and not just in East Asia but in many other countries too. Nobody should suppose for a moment that, after East Asia, it cannot happen again. Turkey and Argentina, to name but two, already confirm otherwise.

Is it infectious?

This account of the forces that drive the cycle of optimism, overborrowing (especially from abroad), excessive risk-taking and crisis may seem plausible for any given individual economy—but one of the hallmarks of recent financial stress has been its multinational character. One country gets into financial difficulties, then another and another. This co-called contagion need not be confined to particular regions. The Russian financial crisis of 1998,



itself a kind of aftershock from the East Asian crisis, put Brazil and other Latin American economies under pressure almost immediately.

Some economists insist that this apparent contagion is not real. They argue that countries make their own way into a position of financial weakness and vulnerability, essentially in the way just described. They object to the term contagion because it implies that the countries and governments concerned are not to blame. Bad news about a neighbouring or similar economy, they say, merely alerts investors to problems elsewhere the markets had been unaware of, or willing to ignore.

On this view, it is not so much the disease that spreads as awareness of the disease. Financial crises may tend to appear in clusters, but the sources of the problem are fundamentally national in character: that is, they spring from the mistakes of borrowers in, and lenders to, a particular country, not from some global propensity to system-wide breakdown.

It is true that contagion will not bring down a financial system which is strong, and that a crisis needs strictly domestic material to work with. Also, some of the economic shocks that trigger crises in more than one country are global or regional in their effects to begin with, such as a change in world interest rates, or a big movement in the dollar or yen, or a big change in the price of oil. If events of that kind start a cluster of crises, contagion is not to blame (any more than one would call it contagion when an earthquake causes neighbouring buildings to collapse).

The fact remains that even an economy

which has been rendered vulnerable by weak supervision, excessive optimism and prolonged overborrowing is not necessarily doomed. If it is lucky, it might pass quietly through that period of danger and emerge on the other side with its vulnerabilities lessened, either by acts of policy or merely as a by-product of advancing economic development. If it is unlucky, it will be affected by bad news just when it is most susceptible. When this happens, it seems reasonable to call it contagion.

A crisis in a neighbouring or similar country might suffice to bring on financial difficulties in just the same way as a purely domestic reappraisal of economic prospects could do: bad news that forces a rethink. Often, cross-border financial flows also come into play, exerting their own direct and powerful influence on events. The evidence points clearly to a "common banker" effect: if two countries have borrowed from the same lender, when one gets into trouble the other can expect to face a squeeze as well, regardless of differences in underlying economic conditions.

There are other channels of contagion too. Equity markets have spells of moving in step, especially in downturns. Rich-country portfolio managers have a tendency to herd together when it comes to investing in emerging markets. When a bank or portfolio manager faces losses in one developing country, it may choose (or be forced by regulators) to sell assets in other markets to shore up its position. If one country devalues its currency, competing exporters come under pressure to do the same, regardless of the effect devaluation might have on corporate and financial balance sheets. All of these factors link economies together.

Because of technology, financial markets move faster than ever before. Partly for the same reason, financial institutions are bigger than ever. When a big rich-country bank changes its mind about the prospects of a particular emerging economy, the effect on asset prices in that economy can be dramatic; all the more so if other rich-country banks decide to join in.

In short, the possibility of contagion certainly adds to the risks of relying on foreign capital, shifting the balance of pros and cons away from openness to capital. For countries that nonetheless still seek access to foreign capital, it underlines the relative attractions of forms that will move only slowly when circumstances change, notably FDI. And it emphasises the dangers of the most mobile and volatile form of capital, short-term bank debt. ■

Safety first

How to handle bank regulation

THE modern history of financial crises emphasises the importance of banks, their tendency to lend recklessly, and the role that deposit insurance plays in creating moral hazard. So are governments having second thoughts about their deposit-insurance schemes? Not a bit of it. Many of them regard deposit insurance as politically unavoidable, and they and their financial regulators are pretty relaxed about moral hazard. There is plenty of talk, and even some action, in regulatory circles about the need for greater market discipline, but no radical rethink of deposit insurance is under way. Rich-country governments continue to export the idea around the world, advising developing countries that deposit insurance is a necessary part of a mature and sophisticated financial system. The number of schemes in place world-wide has been rising steadily for decades (see chart 6).

If deposit insurance and other strands of the official safety-net were dispensed with altogether, an utterly different—and much more cautious—sort of banking would necessarily follow. But this is not going to happen. As a matter of practical politics, abolishing deposit insurance is out of the question. If the safety-net cannot be removed, how then might it be changed to mitigate some of its most harmful aspects? And what other reforms of the way countries regulate banks would

help alongside?

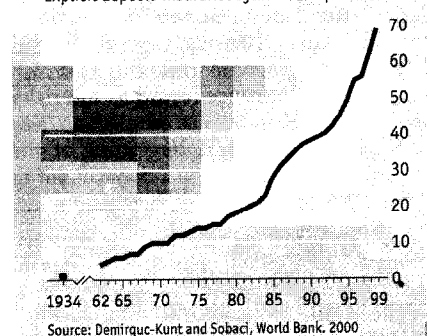
In the aftermath of the savings-and-loan calamity of the 1980s, American legislators passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA). This new law contained several useful measures that need to be adopted much more widely, and especially in the developing countries. The strategy adopted was, first, to narrow the scope of deposit insurance, so that there would be more uninsured creditors with an interest in monitoring; second, to make it harder for regulators and governments to bail out failing banks; and third, to shield bank supervisors from political pressures to exercise forbearance.

A crucial feature of the reforms is the mechanism for “structured early intervention and resolution” (SEIR). Its rules force regulators to act promptly, with a degree of rigour that varies according to the amount of capital retained by the bank or banks concerned. The law defines “well-capitalised” banks as those with capital equal to more than 10% of their assets, with capital and assets both weighted for risk; “adequately capitalised” banks as those with capital of 8-10% of assets; and so on through “under-capitalised” and “significantly under-capitalised”, down to “critically under-capitalised”, with equity of less than 2% of assets.

Well-capitalised banks are rewarded

Catching on

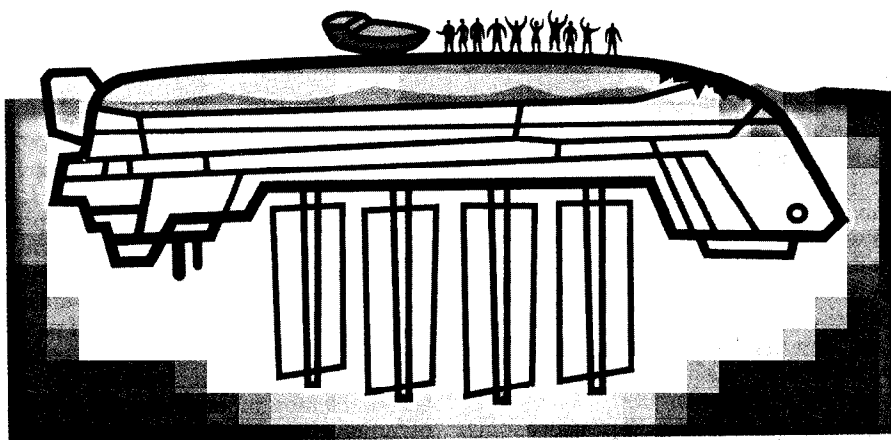
Explicit deposit-insurance systems in operation



for their prudence with minimal regulation. The regulatory burden—with only limited discretion given to the regulators—mounts as the cushion of capital gets thinner. FDICIA requires regulators to tell under-capitalised banks to curb their asset growth, to seek permission for other expansion of their business (such as opening new offices), and to come up with a plan for restoring their capital base. In the case of critically under-capitalised banks, the law tells regulators to close them or sell them, and to require interest payments to unprotected creditors to be suspended.

More generally, the Federal Deposit Insurance Corporation is under an explicit obligation to deal with failed banks in a way that minimises the cost to the deposit-insurance fund. Bail-outs that protect all creditors are not ruled out altogether, in recognition of the fact that sometimes a bank failure might pose a genuine risk to the financial system as a whole. But any such comprehensive bail-out requires the explicit agreement of the president of the United States, two-thirds of the governors of the Federal Reserve and two-thirds of the FDIC's directors.

FDICIA substantially implemented the earlier advice of George Benston and George Kaufman, two of America's leading financial economists, long-time deposit-insurance sceptics and advocates of greater market discipline over banks. They welcomed the change in the rules, but argue that even in America more still needs to be done. Elsewhere, they point out, »



measures like SEIR, to ensure prompt corrective action when banks get into trouble, are few and far between.

Starting in the 1980s, rich-country governments began to co-operate more closely on bank regulation. The growth of cross-border lending made co-ordination necessary, it was argued, otherwise countries with stricter regulation would put their banks at a competitive disadvantage against more mildly regulated banks based abroad. The Basel Committee, founded in 1975 by the rich G10 countries (plus Luxembourg), was given a larger role, and undertook to bring the different national systems of capital-adequacy regulation closer together.

In 1988 an accord was reached. It was based on a two-tier definition of capital, together with a method of weighting risks so that loans and other assets could be measured against capital in a more meaningful way. According to this standard, banks had to retain "tier-1 capital" (equity, mostly) equivalent to 4% of their risk-weighted assets. In addition they had to keep supplementary "tier-2 capital" (including some kinds of debt, loan-loss reserves and, to please the Japanese, 45% of unrealised gains on securities) equivalent to another 4%.

All this was directed at credit risk: the risk that a loan would go bad. In 1996 the accord was amended to take account also of market risk: the risk that the prices of securities or other investments on the bank's trading books would fall, exposing the bank to losses. Banks were allowed to use their own internal models for measuring market risk, subject to some oversight.

The accord did not work well. Criticism has centred chiefly on the credit-risk weights, which were based on very broad categories of asset, and therefore produced judgments far out of line with the market's own finer-grained risk assessments. In reality, risks vary widely for assets within each of the categories. Loans to OECD governments, for instance, which are assigned a zero risk-weight, may vary from rock-solid to not-so-solid. (Mexico, South Korea and Turkey are members of the OECD.) The accord rates loans to companies as riskier than loans to governments—but the market knows that a loan to Microsoft is safer than a loan to Venezuela.

These unduly broad categories created opportunities for banks to game the system, reducing their burden of regulatory capital for any given level of risk (or, conversely, increasing their exposure to risk for any given level of capital). In any case,

the idea that aggregate risk can be estimated by adding up risks in the different categories is wrong in principle. Managing a portfolio to reduce risk involves combining assets with different risks in such a way that the hazards offset each other. The accord, in effect, denies the risk-reducing benefits of diversification.

Worst of all, the accord probably contributed to the Asian crisis. Short-term interbank lending was given a low risk-weight—just a fifth of the weight attached to longer-term lending, or to loans to private non-bank borrowers. Short-term interbank lending played a big part in the region's disastrous credit expansion, with the local banks re-lending the proceeds at high interest rates and in local currency (thus exposing themselves, in addition, to exchange-rate risk).

Try again

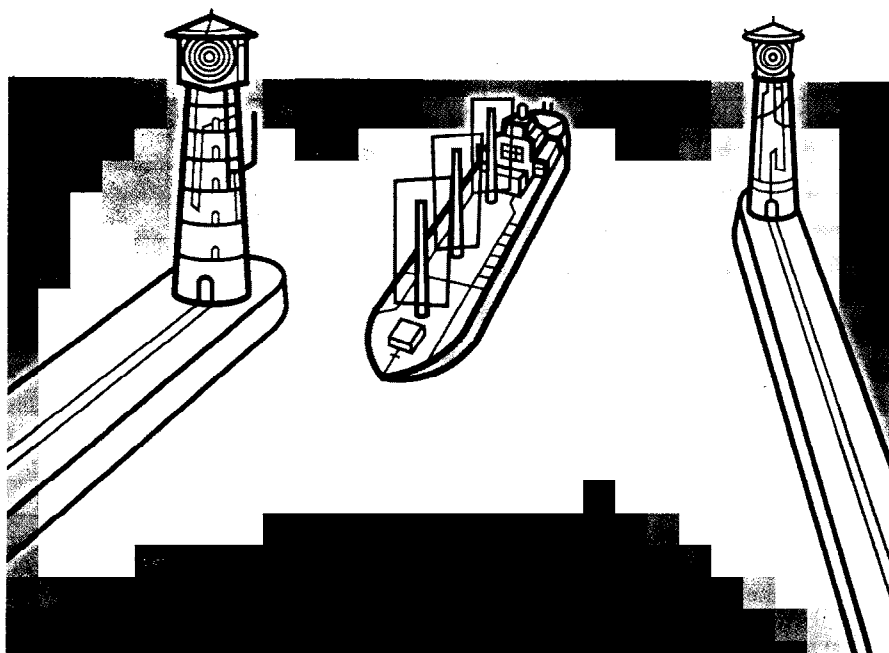
So for the past few years the Basel committee has been at work designing a new accord, Basel 2, which is meant to be finalised by the end of this year and to come into force by the end of 2006. In addition to a great deal of technical tinkering, there are three main proposals. The first is to increase the number of risk "buckets". The second is to give ratings produced by private agencies such as Standard & Poor's a role in calculating the new credit-risk weights. The third is to let banks use their own internal ratings to calculate the capital required for credit-risk purposes (ex-

tending the approach used at present for estimating market risk).

George Benston, George Kaufman and a group of other financial economists who meet regularly as the Shadow Financial Regulatory Committee (SFRC), which lobbies for reform, argue that even this new, improved accord will have serious defects. The adding-up-categories fallacy is still there (though ameliorated by the increase in the number of categories). And relying on private rating agencies also seems questionable, however desirable it may be in principle to draw on wider sources of information. Academic research suggests that the agencies change their ratings too slowly as new information becomes available. Certainly, the agencies' record in the run-up to the East Asian financial crisis was hardly impressive, even if nobody else did any better.

But there are other problems with Basel 2 as well. Banks will design assets to fit particular categories of risk, bending whatever connection there might previously have been between a rating applied after the fact and the level of risk. The agencies themselves will also face a form of moral hazard: they will be tempted to debase their ratings in order to bring banks to their door. As the SFRC puts it, "If the primary constituency for new ratings is banks for regulatory purposes rather than investors, standards are likely to deteriorate."

The proposal to let banks, under supervision, rely more heavily on their own ▶▶



credit ratings is again guided by a good idea—namely, to broaden the base of market-based information feeding into the regulatory process. But it is unclear how the regulators will gauge the accuracy of the banks' ratings, or establish comparability between one bank's method and another's, or what happens if the ratings turn out to be wrong.

Despite all the delays so far, the chances are that something like Basel 2 as it now stands will be implemented in due course—though if it is, its application will be far from comprehensive. America's regulators recently announced that they intend to apply the new rules to fewer than a dozen of their banks, leaving thousands of others to continue with the existing rules. Europe's regulators are aghast. It all makes the case for a thorough rethink seem stronger than ever.

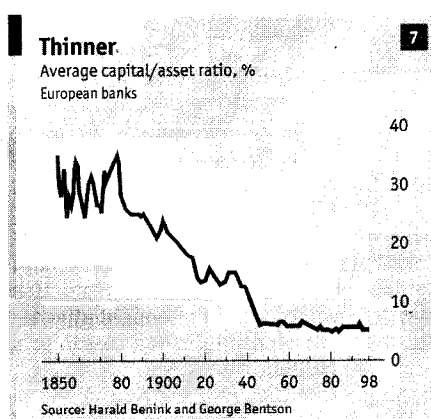
Another way

The SFRC suggests an entirely different method, drawing heavily on FDICIA in its approach to deposit insurance and "early intervention", and in other ways too. The group's alternative has five main parts.

First, measure each bank's capital in a way that reflects market (not book) values and disclose this to the markets regularly. Second, require banks to maintain a level of capital capable of absorbing "almost all losses that would be incurred by reasonably prudent management". Third, let banks meet this capital requirement by issuing subordinated debt (such as uninsured certificates of deposit: in effect, debt which will not be recovered if the bank fails). Fourth, not merely allow but require large banks to issue and regularly reissue a particular form of subordinated debt. Fifth, adopt an improved version of SEIR. The idea is to furnish the financial markets with both the information and the incentives they need to monitor the banks.

In this scheme there would be no risk-weighting. Weights may make sense in principle but in practice, the group argues, they distort lending decisions and fail to convey the information they are meant to. So required capital should be based on a single market-value measure of loans and off-balance-sheet commitments. The muscle of the system is provided by a higher basic capital requirement—the group thinks it should be 10% of total assets—together with FDICIA-style early intervention, and the extra discipline that would come from the use of subordinated debt.

Banks regard a higher ratio of required capital as a tax, which in a way it is. But a



ratio of 10% of total assets does not seem that onerous. Until deposit insurance started in America in 1933, banks maintained capital-to-asset ratios of roughly 15%. Mr Benston and Harald Benink, a European collaborator, have shown that before the creation of official safety-nets in Europe, banks had capital-to-asset ratios of as much as 20% (see chart 7). American banks currently operate with equity-to-asset ratios as little as half those of other financial institutions (such as investment banks, insurance companies and consumer-credit firms).

Moreover, the costs to banks of requiring a higher capital-to-asset ratio need not be great. In some cases it would be zero. Allowing subordinated debt to be counted as capital would help a lot. Many well-run banks already have such capital, and would probably find it cheaper to issue subordinated debt than issuing equity. The main difficulty is not the cost, but the further rules that would be required to ensure that this debt really would be available to meet any losses. If the discipline of subordinated debt is to work, there must be no possibility that the holders of the debt would be bailed out.

Discipline is also the reason why, on this scheme, big banks would be required, not merely allowed, to issue subordinated debt. The SFRC recommends that 2% of assets and off-balance-sheet commitments be backed this way. That would create a group of investors with the best possible reason to monitor the banks' safety: in the event of failure, the holders of subordinated debt lose their money.

Shareholders, too, lose their money when a bank fails. Why, then, does subordinated debt add discipline? The answer is that the owner of subordinated debt, unlike a shareholder, has nothing to gain from a troubled bank gambling on re-

demption by making riskier and potentially more profitable loans. The subordinated-debt holder receives at most the interest on his debt; he has no stake in the upside of any hazardous escape plans, whereas shareholders stand to win the jackpot. This is why the subordinated-debt holder is a better disciplinarian than the banks' owners.

Given all this, subordinated debt does not sound very attractive. Why would anybody buy this uninsured debt if the only return is interest rather than a possible share-price bonanza? Banks would have to induce investors to buy it by paying a sufficiently generous rate of interest. Here lies the beauty of the idea. For a bank judged by the market to be well capitalised and extremely safe, the rate would be low; for a bank judged to be under-capitalised and risky, it would be high. So the cost of capital for safe banks would be lower than for risky banks, which is as it should be. Also, the rate demanded in the market for the debt would be a revealing indicator of perceived risk. Changes in the yield on the relevant subordinated debt could even be given a regulatory role, triggering various stages of early intervention to resolve difficulties at troubled banks.

No doubt there are practical problems in all this, but the basic approach seems a more direct and potentially far more fruitful way of introducing market discipline into bank regulation than Basel 2 as it now stands. At a minimum, a modest version of the subordinated-debt idea should be grafted on to the existing plan as an experiment. Yet whichever basic method is adopted—Basel's finely tuned risk-weights, as seems most likely, or the subordinated-debt approach with early intervention, which may have to wait for Basel 3—it will still fall to national regulators to apply the letter and the spirit of the new rules. In many countries they have been pretty inept at applying the letter and spirit of the old ones.

In the world of financial regulation, forgiveness and forbearance are not virtues. That is why the most urgent change to the way many countries regulate banks is the creation of a legal framework that makes it harder for regulators to turn a blind eye. America's FDICIA shows that this can be done. Other countries should adopt similar measures. These would serve a useful purpose whatever the Basel committee eventually comes up with. If banks can be made safer, that will go a long way towards making financial globalisation much safer as well. ■

Shipbuilding

Developing-country governments still have a lot of work to do if they want to attract the right sort of foreign capital

BBETTER bank regulation is as much a task for rich-country as for poor-country governments. But in addition, the developing countries also need to implement many other financial reforms and improvements of their own. Few of them have the capacity to put imported capital safely to work. This capacity is something that governments can build, but a lot needs to be put right before openness to capital can be relied on to bring net benefits rather than net disappointment.

Reducing corruption would be high on the list even if economic efficiency were the only concern. Corruption particularly discourages inflows of FDI, the safest and most productive kind of capital inflow, so relatively speaking it favours bank lending, the riskiest kind of capital (see chart 8).

Work on the connection between corruption and the mix of capital inflows has been reviewed in a paper just published by the IMF. However corruption is measured, the answer comes out the same: corruption discourages inward FDI. Indeed, it appears to discourage it even more than do high corporate taxes.

Many developing-country governments, keen nowadays to attract FDI, try to appeal to investors by cutting corporate taxes or by offering subsidies. This often works, but the cost is quite heavy, and goes beyond the mere fiscal outlay or forgone revenue. Governments in most poor countries have to rely on a narrow tax base. They find it difficult to pay for social spending and economic infrastructure while keeping their own borrowing under control. Macroeconomic stability, as noted earlier, is an important contributor to financial safety. Special tax breaks for FDI may militate against such stability—and run a far greater risk, too, of distorting FDI decisions in favour of inefficient projects. In every respect, curbing corruption is a far better method of attracting FDI.

Reducing corruption is hard but not impossible. Measures include explicit restrictions on connected lending, better accounting standards and greater disclosure of financial information (and not just for the banks). In many countries, legal reforms will be needed as well. A constant theme of much of the recent research on fi-

nance and development is the importance of strong property rights. Without them, it is difficult, for instance, to offer collateral against a loan, or to resolve bankruptcies quickly and smoothly.

Faster and more accurate disclosure of information too is desirable in itself, for governments as well as for banks and private companies. A study by Gaston Gelos and Shang-Jin Wei, quoted in the IMF paper, looked at the investments of international equity funds between 1996 and 2000 to see if there was a connection with "transparency", measured in a number of different ways. It examined disclosure not just in the corporate sector but also in the release of official macroeconomic data and in the running of macroeconomic policy. All three aspects of transparency were found to be related to inward portfolio flows, even after allowing for the effect of many other factors (for example, incomes and market liquidity).

And these effects were big. For instance, on the macroeconomic-data measure, transparent countries received a share of global equity investment that was 48 percentage points higher than their market capitalisation (as a share of global market capitalisation) would suggest. Non-transparent countries received a share that was 25 percentage points lower than the same benchmark (see chart 9 on next page).

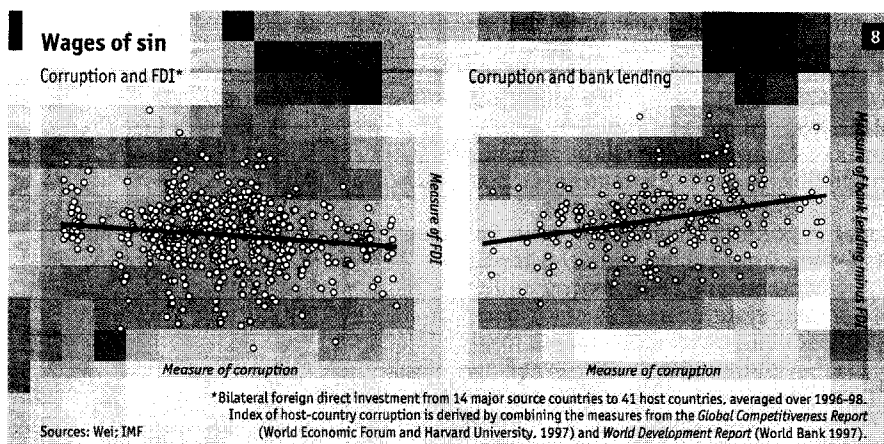
The same study found that herding among investors was substantially lower for countries with good disclosure than for

the rest—presumably because greater transparency gives investors something more substantial to go on than what other investors are doing. Less herding is a good thing: when investors follow the crowd, they amplify the economic cycle, driving output and asset prices higher in booms and lower in slumps.

Also, in the event of a financial crisis, capital flight seems to be less of a problem in countries with better transparency. Again, this may be because information equips investors to see beyond the short-term emergency to more reassuring long-term fundamentals. "Overall," the study concludes, "the data suggest that an improvement in transparency might very well reduce the so-called sudden-stop phenomenon of 'hot money', and hence increase the stability of the domestic financial market in a developing country."

There is evidence that ownership of the banks and other financial institutions in developing countries matters a lot. Most governments restrict foreign ownership of banks. State ownership, on the other hand, is typically extensive. It would be far better the other way round.

Foreign ownership of banks is just a particular form of FDI. In many ways, therefore, the benefits to the host country of foreign-owned banks are simply the financial-sector equivalent of the broader benefits of FDI. These include not just the initial capital inflow itself but also the introduction of better technology and new ▶▶



management skills, not to mention greater competition for the existing domestic institutions. But in finance there are additional advantages as well. The task of financial regulators is easier if foreigners come into the market and establish new and higher standards. With a heavy presence of foreigners, the government is much less likely to bail out the banks en masse if they get into trouble. Uninsured depositors will accordingly feel that much less secure—which is all to the good, from the standpoint of discipline and monitoring.

Banking-sector FDI also helps to fight corruption. Foreign-owned banks have their reputations at home and around the world to consider, not to mention their home-country regulators, so they will be less susceptible to corruption than incumbent domestic banks. They also have good reason to monitor what domestic banks are doing, and to expose corruption when they find it. From their point of view, improper conduct is a kind of unfair competition that puts them at a disadvantage.

Possibly most important of all, banking-sector FDI promotes diversification, which is a good way of reducing risk. The business of domestic banks in developing countries tends to be heavily concentrated at home. If the local economy turns down, all of their activities are exposed. Foreign banks have a far wider spread of risk, and can call on head office to help if need be.

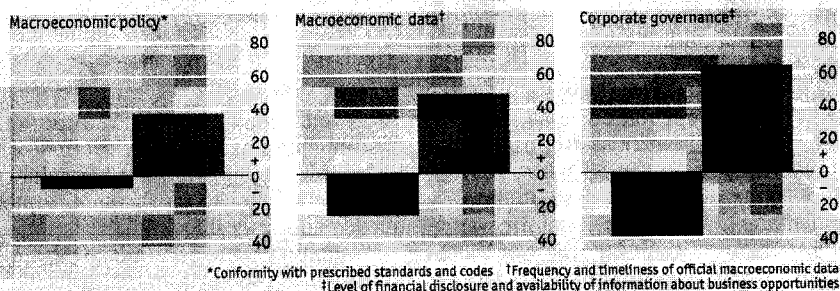
For every advantage that banking FDI offers the emerging-market economy, state ownership brings with it a corresponding disadvantage. State-owned banks often institutionalise practices that would be called questionable or corrupt if undertaken by private banks. Connected lending, for instance, is not so much a consequence of state ownership as its very purpose: the whole idea is to make lending decisions on the basis of non-economic tests. This means state-owned banks must be expected to make losses, and will have to be sheltered from competition. Regulatory forbearance, in the same way, is not just likely, it is required. Monitoring by depositors and other creditors will be minimal: the promise of bail-out is as clear as it possibly can be. The evidence confirms that countries with the highest proportion of state-owned banks have the highest bank operating costs and the largest proportion of non-performing loans.

In addition to promoting access to information and curbing corruption—where greater foreign ownership can be of great help—developing-country governments need to weigh the case for explicit restric-

Transparently attractive

Foreign investment by mutual funds, actual % share of total minus expected share of total

Countries rated: ■ opaque ■ transparent



Source: "Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence", by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose. IMF, March 2003

tions on certain kinds of financial activity. In systems that are otherwise clean and well-run, the need for further measures might be limited. Even then, some action may seem advisable, especially since bank regulation is likely to remain far from ideal. But in systems that are neither clean nor well-run, and where governments would find it difficult to put this right by more direct means, narrower restrictions may be necessary. Two kinds of capital stand out: short-term debt, and debt denominated in foreign currency. Short-term foreign-currency debt, combining the hazards of both, is therefore a prime concern.

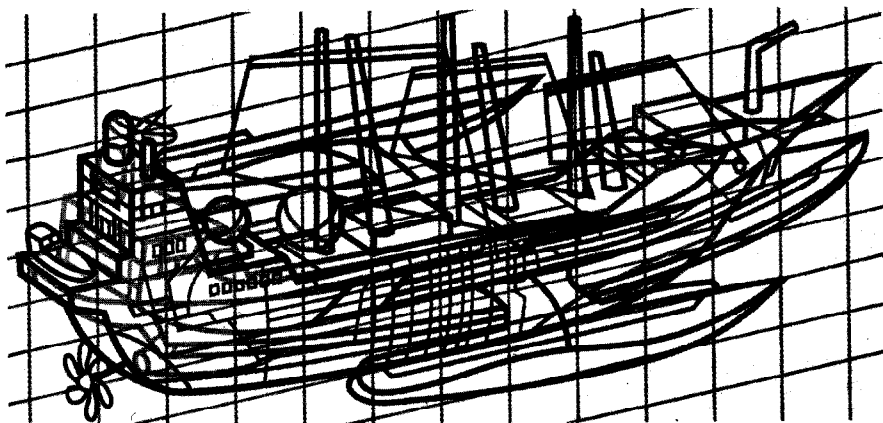
Unpegged

Today the exchange-rate danger, at least, is smaller than before—not because currencies are more stable, but because the fragility of systems that merely appear to be stable is better understood. Fixed but adjustable exchange rates helped to worsen the plight of the East Asian economies and others in the late 1990s. The promise of a stable currency helped to draw in too much of the wrong sort of capital.

Then, when events forced a devaluation, the economies concerned found themselves in trouble twice over—once for over-borrowing in the first place, and then again because many of those debts had to be repaid in dollars or other hard currencies which had appreciated in the meantime.

The economic problem is even worse than this, because a heavy burden of foreign-currency debt makes it difficult for the government to cushion an economic slowdown in the orthodox way, by lowering interest rates. If it does that, it is likely to speed the flow of capital out of the country. This will drive the currency down further, increasing the burden of foreign debt yet again and dragging the economy into an even more ferocious recession.

Here, if nowhere else, lessons have been learned. All over the developing world, fixed but adjustable currencies have been replaced by more flexibly managed regimes (either pure floats or, more commonly, managed floats). Under floating-currency arrangements, the foreign investor comes in with a more realistic idea of the exchange-rate risk, and if the econ-



omy does get into trouble, the simple one-way bet of withdrawing capital before the currency peg gives way becomes more complicated. That is likely to encourage stability, both by tempering the inflow of capital during upswings of market sentiment and by encouraging long-term flows at the expense of short-term ones.

In other respects as well, international monetary arrangements are improving, albeit more slowly. The IMF, for instance, has a keener sense of the harm that can be done by letting investors believe that it will protect their investments come what may: moral hazard, yet again. A great deal of attention has concentrated lately on making sure that, once a crisis strikes, investors fully share in the losses—and that they will be well aware of this in advance.

But although understanding of the IMF's role has improved, policy for the most part has not. The main reason is that big financial crises are usually political crises as well. It is the way of the world that, at such times, economic principles are swiftly set aside. Generous IMF support, pushed through by powerful members (notably the United States), has often been granted for political rather than economic reasons, and will continue to be.

Also, as the Basel bank-regulation saga confirms, institutional reform that requires international consensus takes years, if it happens at all. Anne Krueger, the Fund's deputy managing director, has proposed a scheme for dealing with "sovereign bankruptcy", which among other things would allow investors' losses on

loans to developing countries to be apportioned faster and more predictably. It is a good plan, and has won the support of many expert observers. But many governments, including America's, are not keen. At the moment, its prospects look poor.

Besides, the extraordinary attention paid to reforms of the "international architecture" over the past five years has been out of proportion to its real importance. As this survey has argued, it is the quality of national financial policy, in rich countries and poor countries alike, that decides the safety of the global capital market. If that policy is wrong, no reform of the IMF or changes to other aspects of the international architecture, however ingenious, is going to make cross-border capital safe and productive. ■

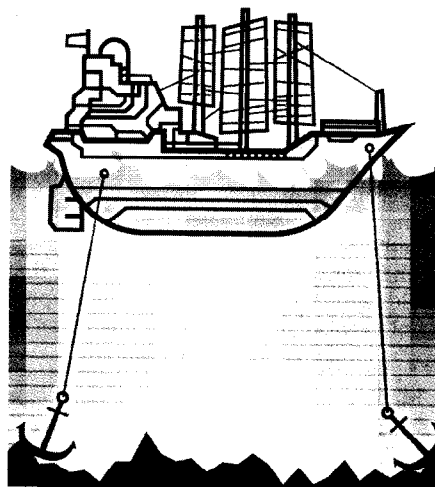
A slightly circuitous route

Where capital controls make sense

MALAYSIA responded to the financial crisis of 1997-98 by violating one of the most sacred canons of economic orthodoxy: it imposed exchange controls. The government started supervising all foreign-currency transactions for financial (as opposed to trade) purposes. The policy was draconian, especially by the standards of the financial freedom the country had enjoyed up till then. Suddenly it was illegal to take even \$100 abroad. The aim was to allow the authorities to ease fiscal and monetary policy without provoking massive capital flight. Some economists think that the policy was a success, and advocate something similar for other developing countries. A few even see it as a way to prevent crises in the first place, not just to help deal with existing emergencies. Are they right?

They have a point. Liberal economists, who for years rejected the mere possibility that capital controls might make sense, need to acknowledge that the long-standing orthodox prohibition on any and all of them was far too confident. For the IMF, capital-account liberalisation as quickly as possible was until recently an article of faith. The Fund told South Korea to press on with liberalising its capital account even as the crisis of 1997-98 was unfolding.

This newspaper, too, long maintained that capital controls are always wrong. Yet the evidence reviewed in this survey



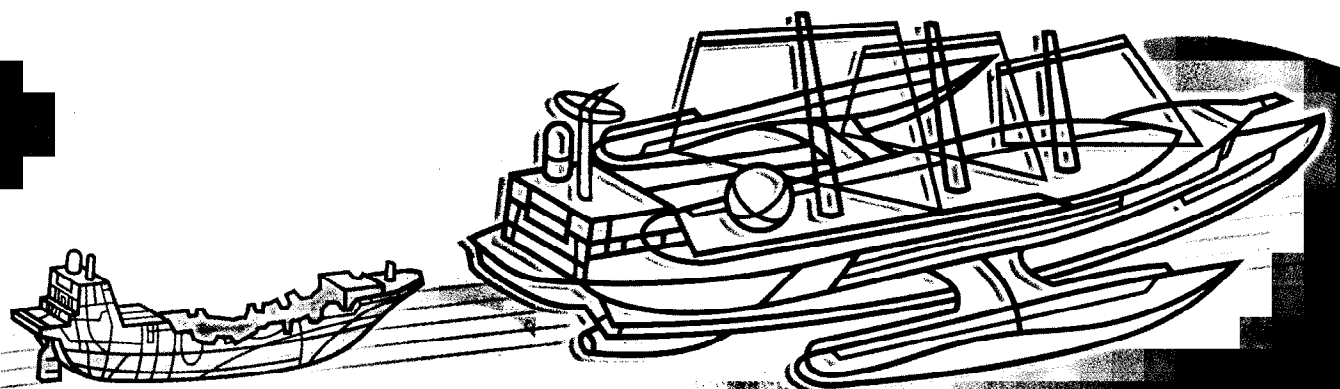
shows that the global capital market is a turbulent and dangerous place, especially for poorly developed economies that may be ill-equipped to navigate it. To be sure, capital controls are not the best way to prepare; but for some countries, imposing certain kinds of control on capital will be wiser than making no preparations at all.

In rich economies, with their deep and diversified financial markets, honest and competent regulators, and macroeconomic policies that keep public borrowing and inflation in check, a liberal regime for capital flows works best. Indeed, it works

so well that the policy arouses next to no debate. There may be arguments about the details of bank regulation or fiscal policy, but nobody seriously proposes that the United States, say, should introduce exchange controls. Even if it were still possible to control capital flows that way—which it would not be, given the sophistication of America's financial institutions—who would want to? The benefits of financial integration are clear to all investors, and any economic costs vanish by comparison. Moreover, in most rich countries the ability to move capital across borders is seen as a matter of personal liberty. If a government wanted to stop its citizens from moving their savings abroad, it would have a lot of explaining to do.

Timing is all

As a medium- or long-term goal, emerging-market economies too should aspire to regulate cross-border capital as lightly as rich countries do—as a matter both of economic efficiency and of individual freedom. Nor does this mean that they must wait until they are rich before they liberalise capital: that would keep them poor much longer than necessary. What it does mean is that they must improve the standard of their monetary and fiscal policies; deepen, diversify and deregulate their domestic financial systems (not least by allowing foreign ownership of banks and other finan- ►



cial institutions); and upgrade their standards of financial supervision (especially of banks).

Once they are more like rich countries in these three respects, and long before they have closed the income gap, they can liberalise access to foreign capital in comparative safety. All the while they should be encouraging inflows of FDI—not with subsidies, but by curbing corruption and strengthening property rights. When they start to reach those higher standards of economic policy and institutions, the benefits of inward-portfolio investment and, later, offshore bank finance will increasingly outweigh the costs as well.

It is a cumulative process, and each step poses difficulties of its own. The need for better bank regulation is nowadays widely understood—but, judging by experience to date, that does not make the underlying dilemma of systemic stability and moral hazard any easier to resolve.

Essentials

The importance of macroeconomic stability, and especially of fiscal conservatism, continues to be underestimated. Yet if a government cannot keep its borrowing in check, it must either force domestic banks to absorb its debt (ruining any chance of creating a profitable, lightly regulated and efficient banking system) or else simply print money, thereby fuelling inflation and destabilising the currency. Now that floating exchange rates predominate, fiscal caution is even more important than before. The simplest principles of public finance are still the foundation for everything else. This is one article of faith the IMF need not renounce.

But until progress in these areas is well under way, some kinds of restriction on inflows (not outflows) of capital will make sense for many developing countries. Chile's well-known system of holding-period taxes subjected imports of capital to a one-year 30% non-interest-bearing deposit. It failed in its stated goal of reducing total capital movements, but managed to tilt the balance away from short-term towards longer-term inflows. In that respect, it was a success worth emulating.

A tax on short-term inflows has the advantages of relative simplicity and transparency. It resists bureaucratic subversion. Moreover, just as tariffs are a more efficient way to restrict trade than import quotas, so taxes are a much less costly way of managing capital inflows than blunt restrictions on quantities. A regime such as Chile's still allows access to short-term capital, albeit at a price.

Over time, it seems the regime became less effective and more subject to evasion, but that is of no great concern. As the financial system becomes more sophisticated, the need to discourage short-term inflows recedes anyway. The important thing is to ensure that standards of supervision rise in tandem with the institutions' growing depth and breadth.

Until recently, financial orthodoxy set its face against restrictions of the Chilean sort. They still make the IMF uncomfortable. In its free-trade negotiations with Chile and Singapore, the United States has also frowned on capital-account restrictions, though it was willing to compromise. Instead of reluctantly acquiescing, rich-country governments and the Fund need to start recommending such policies. If they must, they can tell themselves that holding-period taxes are not really capital controls at all, but simply another form of

prudential regulation. In any event, developing countries should be advised to use this method until their financial systems are ready to participate properly in the global capital market.

Rich-country banks will oppose this, because they would be the principal losers from new impediments to short-term bank inflows to developing countries. But, helpfully if incidentally, their opposition might oblige the IMF and its most powerful members to endorse such policies explicitly, instead of merely tolerating them. This would make it clear that the global capital market is not, as is sometimes alleged, being run for the benefit of rich-country banks.

No greater prize

The world's poorer countries have a great deal to gain from the global market for capital, and should do their best to take advantage of it. But they need to approach the opportunity more cautiously than in the past, and better prepared. If rich countries also improve their own financial policies—which they should, in their own interests—the market will become even safer for all its participants. The international market for capital is already vast, but its potential for promoting growth where it matters most has hardly begun to be tapped. ■

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